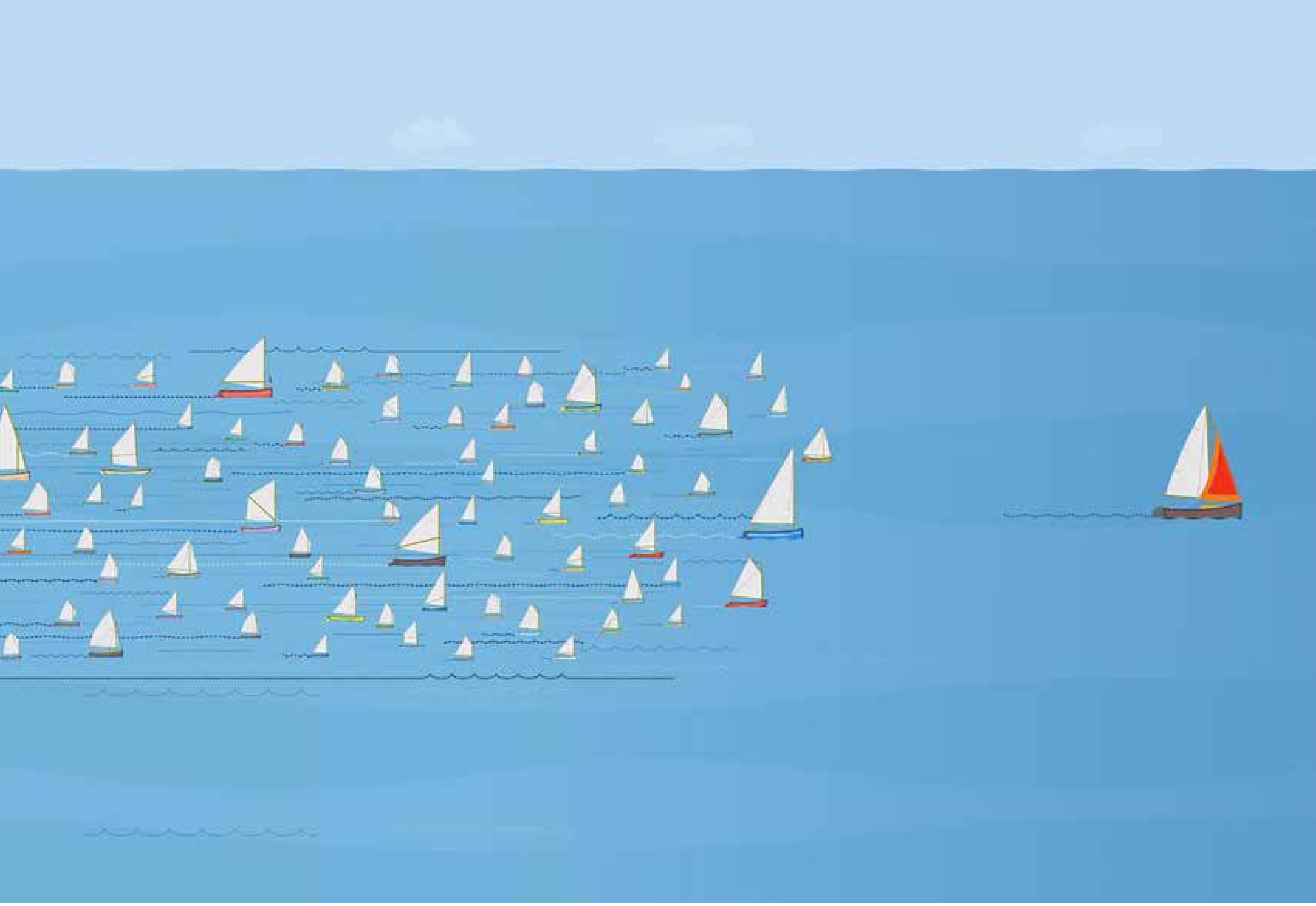


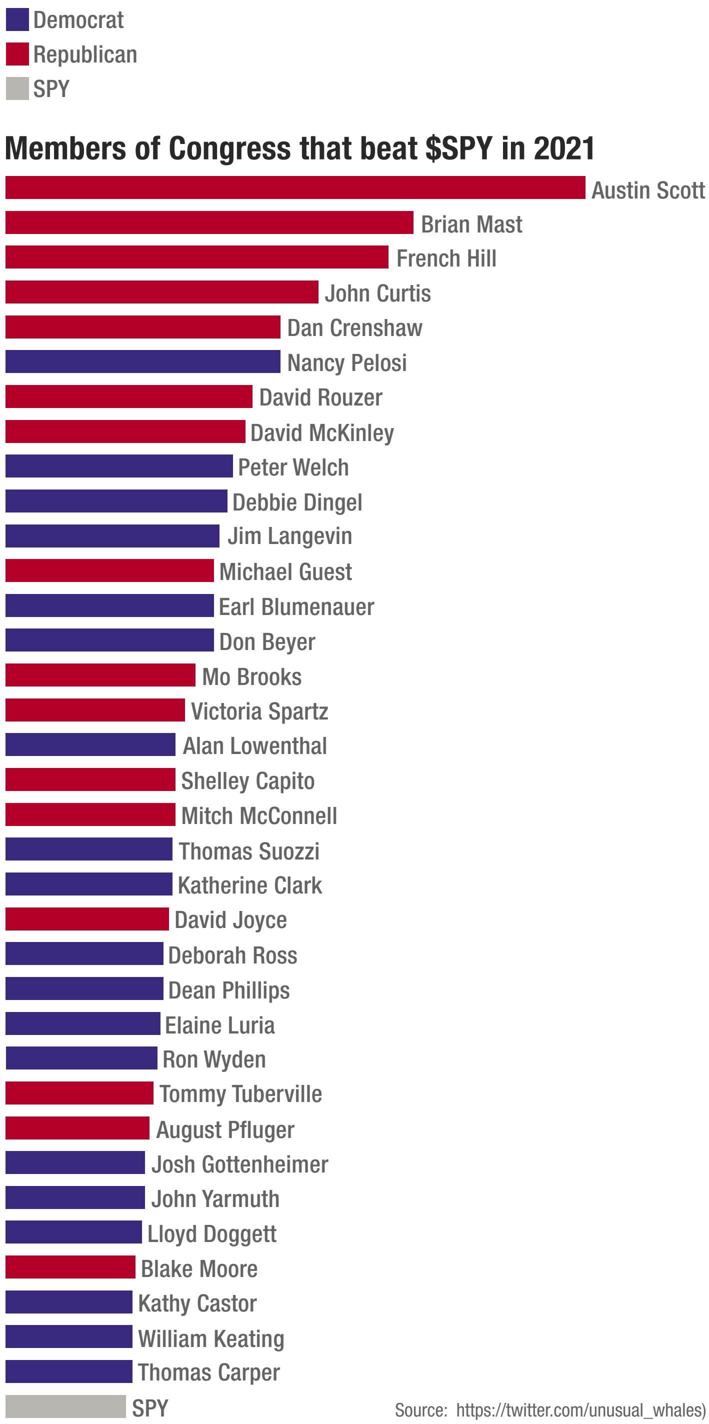
Inflation's Antidote

2022 is shaping up to be a year of big questions.

Will inflation subside?
Will this bull market keep going?
What will happen to crypto?
Will the Democrats hold on to power in the midterms?
Will Russia invade Ukraine?
Will China invade Taiwan?
Will this pandemic ever end?

The thing that makes thinking about the investment landscape in 2022 so difficult is that it's hard to even imagine a scenario where we manage to get through this inflationary pulse without some real damage to asset markets and the economy. Of course, anything is possible. To get the goldilocks scenario though where this long-running (almost everything) bull market continues, we would need inflationary pressure to somehow just dissipate and fade away like a dying wave. Maybe if supply chain dynamics return to "normal," whatever that means, something like this could happen. But not only would production have to smooth out—which seems highly unlikely given the state of the virus in the world, just ask anyone who tried to travel during the holidays!—but also demand itself would have to shift again. Households and companies would have to step away from new behaviors, like buying just-in-case instead of just-in-time or doing whatever humanly possible to buy a home. Seems pretty unlikely.

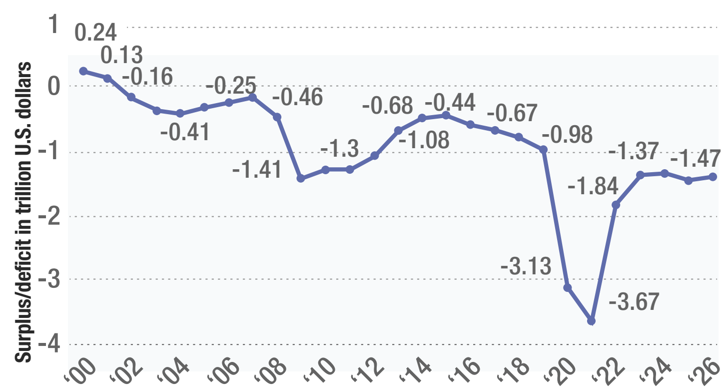
On the political front, things are weirder than ever. I'm convinced our elected leaders have almost no idea what they are doing when it comes to the economy and inflation. There's a clip circulating on Twitter of Vice President Harris trying to answer a question about inflation and her response is so nonsensical it's scary. Depending on how you want to make yourself feel today, check it out. On a different front, it's becoming more and more obvious that our elected leaders do, however, seem to know a thing or two about trading stocks. Twitter has been on-fire lately, mostly with stories of Nancy Pelosi's apparently incredible track record. There are multiple dedicated Nancy Pelosi stock trade tracker accounts and a bunch of viral threads on the topic. This all started when a few Fed Governors got called out, criticized and ultimately resigned as the public got wind of their interestingly timed stock trades. With Pelosi, the suggestion, of course, is that her track record is so good—i.e. better than Warren Buffett and just about every other superstar investor—that she must be trading on some serious inside information (like the individuals at the Fed). Who knows! You obviously cannot trust everything you read on Twitter. Either way it's interesting though, as is this:



Should we expect anything less from members of our Congress? This is America, a place where there's always been a much tighter connection between business and government than people care to admit. Even with the Founders, this sort of quasi-insider trading was a thing. Check out Charles Beard's 1913 "An Economic Interpretation of the Constitution of the United States" for a kind of mind-blowing analysis of the rather interesting trading activity of many of the signers of the Constitution. Different times, different instruments (government debt securities) but the same results.

Finally, let's not forget about this whole thing with Manchin. I'm not sure what's behind his abrupt turn against Biden and his watershed legislation package. Perhaps Trump promised him the VP slot on his 2024 ticket? Wouldn't that be interesting? In any event, with the midterm elections looming it probably signals the end of the aggressive expansion in fiscal deficits. This should take some inflationary pressure out of the system at least.

Surplus or deficit of the U.S. government's budget in fiscal years 2000 to 2026 (in trillion U.S. dollars)

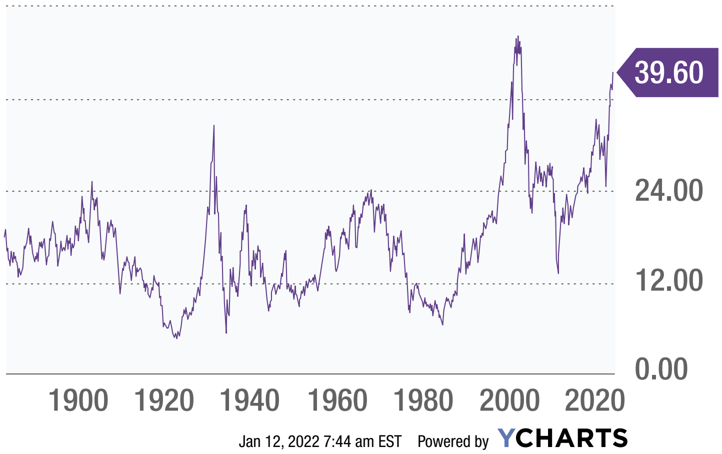


Source: US Office of Management and Budget ©Statistica 2021

As for the Fed, I almost feel bad for them. They are going to have to pretend to move aggressively enough to convince the market that they can still be effective against inflation. Yes, I know that statement is confusing! But I say "pretend" because there's no actual way the Fed can raise rates high enough to make a difference. With Fed Funds at 0%, the 10-year at 1.75% and official inflation at 7% (and properly measured inflation at 10% plus), they are going to have to do something not quite impossible, just incredibly difficult: convince the market that the combination of tapering QE and three itty bitty rate hikes can do the trick. No, I'm not going to bet on this.

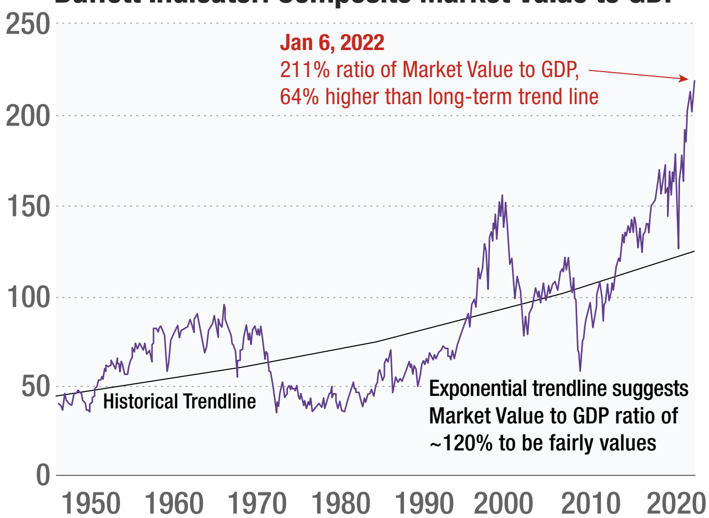
So, we are starting 2022 with an inflation problem, a messed-up political scene and a precariously positioned Fed. To make matters worse, asset markets are sitting at rather extreme levels. In terms of equity valuation, we've already surpassed the Roaring 20's levels and are approaching the level last seen during the dotcom mania:

S&P 500 Shiller CAPE Ratio



The Buffett Indicator, which compares total stock market capitalization to GDP is also looking kind of crazy:

Buffett Indicator: Composite Market Value to GDP



Source: www.currentmarketvaluation.com/models/buffett-indicator.php

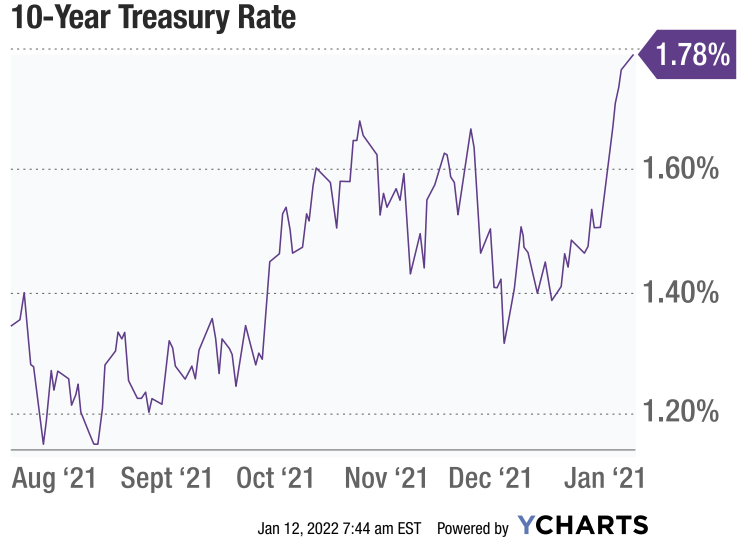
Part of me thinks the smart move today is to significantly de-risk and go to cash. But then there's this whole inflation problem. With inflation running at 7%, holding cash is incredibly punitive. So that's not really a great option.

What are we to do?

As part of what I guess is a kind of annual rite of passage in the investment world, I've been thinking a lot about the question of portfolio construction. In light of everything we just discussed, what do we do now? How do you construct a sensible portfolio today? Even though the turning of another page on the calendar shouldn't really matter—it's an artificial milestone in the true investment horizon—it's hard to resist the temptation to think of and evaluate things in neat little annual blocks of time. It's only human nature, right? It's actually more than that too. We cannot forget that each year the bonus scorecard resets on Wall Street. Investors and traders across the entire money management landscape are presented with a blank slate and the mandate to "go forth and make money!" Everyone is out rebalancing, resetting, and expressing new ideas for the new year and with this reset of the incentive slate often comes regime change in asset market behavior.

Anyway, this portfolio construction question is a very hard question to answer. It's tempting to think that it might be as simple as adding some traditional inflation hedges like gold, commodities, and inflation protection Treasuries to this portfolio. However, I'm worried these trades might not even work this time around! The entire market is addicted to low interest rates and accommodative Fed policy and if the reality of sustained inflation sets in, every asset will be vulnerable. We've already seen in the early days of 2022 the market reacting very negatively to Hawkish Fed minutes and what in the grand scheme of things is a tiny move higher in rates:

10-Year Treasury Rate



When you zoom out a bit, you see that this "move," if you can even call it that, is nothing:

10-Year Treasury Rate

Imagine how the markets will respond if rates really start to move back in the opposite direction. I'm not saying that everything will necessarily go down as rates go up but they certainly might and that's the scary part.

Anyway, here's what I've come to believe: no matter what you think about inflation, the prudent thing to do today is to make aggressive moves to protect yourself against it. Holding a ton of cash is just a non-starter. Every dollar that sits in the bank earning nothing, depreciates to the tune of at least 7% (CPI measured inflation) and almost certainly more in terms of real purchasing power. And 7% is no joke. That's very close to the long-term average annual gains for the stock market. So, to sign up to just lose that this year by doing nothing is obviously a very bad idea.

> **I think there is a way to create a portfolio of publicly traded securities and cryptocurrencies,** which won't quite replicate the exposure offered by the private start-ups but will expresses the energy of the entrepreneurial profit potential.

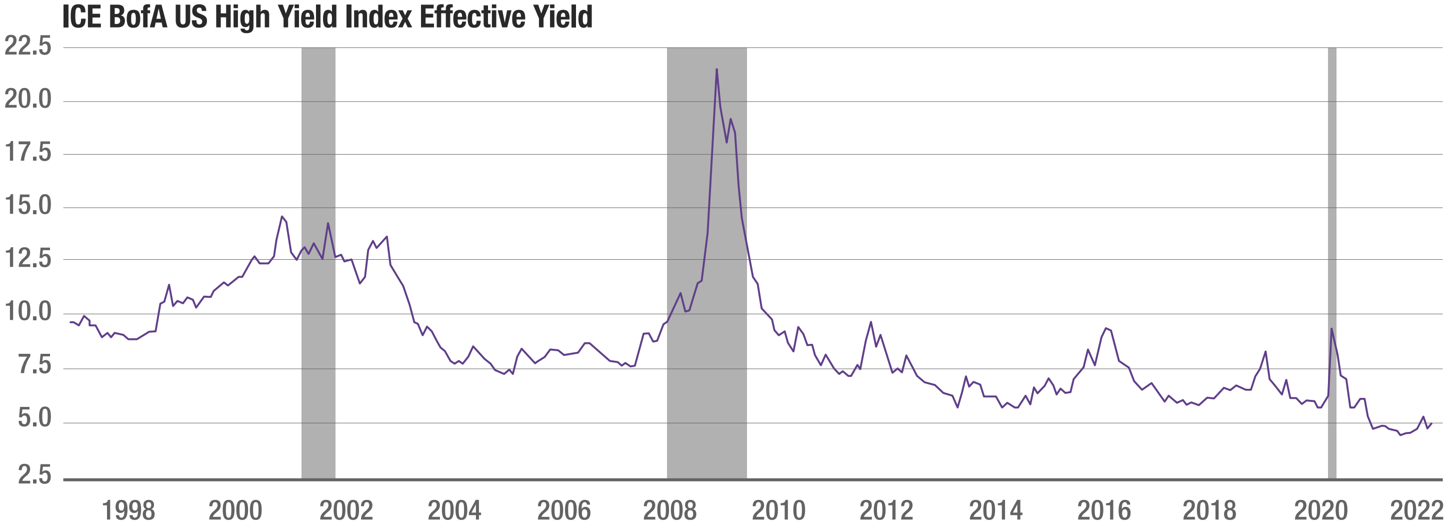
Nothing is easy these days. After a decade of extremely aggressive monetary policy, the bond market is so messed up that there's literally nothing you can do there. You could invest in "high-yield" junk bonds and earn a measly 4.5%. Look, at least with this your guaranteed loss would only be 2.5%. Big win, right!? You could break even and maybe even make a percent or two by jumping into my world and lending money at 7-10% to real estate entrepreneurs! How viable of an option is that though? The truth is that for the vast majority of investors out there, the bond market is offering absolutely zero rational possibility. So, out and out on the risk curve we must go and remember, this is just to keep pace with inflation! We're not even talking about making "real" returns yet. Let that sink in for a second.

Does this mean we should just give up all pretense of prudence and throw our hats in the ring with the speculators? It kind of feels that way at times. Maybe we should just "ape" into OHM for that 150,000% APY or the next NFT drop. We could always join the meme stock crowd or if we feel like being "more sophisticated" jump in the shorting volatility trade. Better yet, maybe we should just follow Nancy Pelosi's purported trades and get long options on big tech and big media.

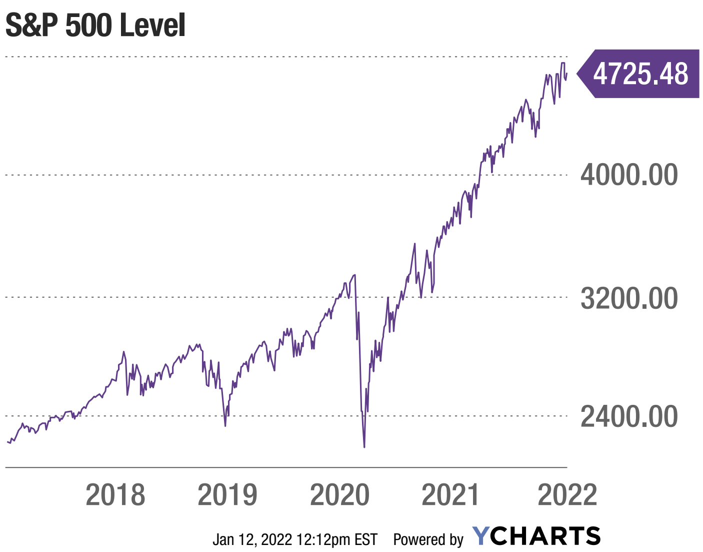
The truth is I understand the sentiment behind each and everyone of these ideas completely, as wild as some of them are. I get it. The world is presenting in crazy ways these days and I get the feeling that just about anything could happen. I'm not ready to throw all caution to the wind yet. I think there's a better way where we can still at least attempt to be prudent. There is basically one good rational antidote left.

At the risk of beating a dead horse, let's restate the problem. Inflationary pressure has emerged into our world at a time when monetary authorities around the globe have fundamentally limited their own ability to fight inflation. They have backed themselves into the ultimate policy conundrum corner. What this means is that if inflation proves to be

ICE BofA US High Yield Index Effective Yield



Shaded areas indicate U.S. recessions — Source: Ice Data Indices, LLC — fred.stlouisfed.org persistent, central banks will have to choose between letting inflation run or wrecking asset markets. I don't see how they choose the latter…ever. At best, they can engineer enough of a cooling off of the economy to quell inflation while keeping markets relatively flat. While I think this goldilocks scenario is possible, we cannot count on it. That leaves us staring at a pyrrhic choice. In the inflation scenario we risk losing the purchasing power of our hard-earned income and savings. In the wrecked asset market, we risk losing money through capital loss, which could be massive. Just look at this chart:



There's a ton of room between where we are today and the pre-COVID trend line.

So, what should we do? I believe the only good antidote to the risks posed by inflation today is to be aggressively entrepreneurial and if you cannot do so yourself, find some way to replicate that kind of energy in your portfolio. Why? With globally suppressed interest rates and extremely valued equity markets, only the entrepreneurial profit will be enough to get you through to the other side of this situation. You cannot hold cash. You cannot buy bonds. You probably cannot even buy equities. Commodities and real estate might work for a while but eventually inflation could eat away at their returns as well—i.e. if their costs inflate faster than income. Given the strength of the ESG movement and the specter of carbon pricing, this looks likely to happen. I'm convinced that this time around you've got to throw out everything you've ever learned about how to protect yourself from inflation.

Interestingly, I think this is something the market has already figured out. I don't believe in market efficiency or anything like that. That's all nonsense. The market is a manifestation of human behavior, which, let's be honest, is only rarely rational. However, the market itself has this uncanny, almost magical, ability to reveal the truth…eventually. The hard part, of course, is figuring out when. Anyway, in this case, I think the market is on to something. Last year, not only did crypto go bananas, but we also shattered all previous records in start-up funding. Globally, investors poured $671B into private company start-ups, up 90% from 2020, the previous record year! In the US, the story was the same—$329.8B in private start-up funding, up from the previous record in 2020 of $166.6B. These are massive numbers in absolute and relative terms. Is this just irrational exuberance or, perhaps, evidence that we are approaching the singularity? I think not! What I see here is the market telling us something important: "entrepreneurial returns are your only chance!" Whether the investors who made these bets did so because they were concerned about inflation is beside the point. What matters is that the opportunities were there and they took them instead of something else.

Let me explain why. One of things we have learned from behavioral science is that people rarely "really" know why they do what they do. In other words, subconscious / unconscious forces drive a lot of human decision making. Carl Jung had this fascinating theory about this. Given that it's hard to know a person's actual intent—you cannot just ask them and rely on what they say—Jung postulated that perhaps a better way to understand a person's intent was to look at the results of the decision or action and infer the intent from there. Using Jung's framework, I think what we can infer from the astonishing entrepreneurial activity in 2020 and 2021 that investors have figured out, subconsciously at least, that they need the high potential returns offered by these types of investments if they want to have any chance against inflation.

Just how does one get exposure to entrepreneurial profit? The best bet, of course, is to be an entrepreneur. I realize that this isn't a viable path for everyone but if it is, I encourage you to lean in and pursue this path aggressively. The second-best bet is to invest alongside sophisticated private start-up investors. Again, sadly, this is an option not readily available for almost everyone. What, then, can be done? I think there is a way to create a portfolio of publicly traded securities and cryptocurrencies, which won't quite replicate the exposure offered by the private start-ups but will expresses the energy of the entrepreneurial profit potential. I will be dedicating almost all my time in the first few months of this year to put this portfolio together. *Stay tuned for updates.* ▫